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Client Alert

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If it Walks Like a Duck…*In Re Duckworth*: Another Warning to Lenders to Take Care in Drafting Security Documents

A lender loans a borrower a substantial sum of money, memorialized by a promissory note, secured by certain goods owned by the borrower under a security agreement. The note expressly references the security agreement. Sounds like a fairly straightforward transaction — except that the security agreement misidentifies the date of the Note. The mistake goes unnoticed. Now the borrower has filed a Chapter 7 bankruptcy petition. Can the lender use evidence outside the four-corners of the security agreement to prove that it has a valid security interest against the bankruptcy trustee?

Unfortunately, a recent Seventh Circuit decision providing guidance on this issue holds that the lender's lien is invalid against the bankruptcy trustee for borrower's other creditors. In *In Re: David L. Duckworth*, Nos. 14-1561 and 14-1650 (7th Cir. November 21, 2014), the Seventh Circuit explained that the mistaken identification of secured debt cannot be corrected by using parol evidence to show the intent of the parties to the original loan. In this matter, a $1,100,000 Promissory Note was executed in favor of the State Bank of Toulon by Duckworth on December 15, 2008 (the *"December 15 Note"*). A separate Security Agreement granted the Bank a security interest in crops and farm equipment. The Security Agreement mistakenly stated that it secured a Note dated *December 13, 2008*, rather than correctly referencing the date of December 15.

Thereafter, Duckworth filed a petition for bankruptcy protection under Chapter 7 of the Bankruptcy Code. The Bank filed adversary proceedings, and the bankruptcy court held that the mistaken date in the Security Agreement did not defeat the Bank's security interest. The Chapter 7 Trustee (*"Trustee"*) appealed to the district court, which affirmed the bankruptcy court's ruling. The Trustee then took the matter up to the Seventh Circuit.

The Seventh Circuit reversed. The Trustee argued that the Security Agreement failed to grant a security interest to secure the December 15 Note because it unambiguously identified non-existent debt. The Court first analyzed the text of the Security Agreement itself and concluded that the Security Agreement unambiguously referred to a Note dated December 13, 2008, a note that simply never existed, and the plain text of the Security Agreement failed to incorporate the December 15 Note.

Next, the Court took up Lender's argument that parol evidence — evidence outside the four corners of the document — could be used to read the Security Agreement as securing the December 15 Note. The Bank contended that because the Security Agreement would be enforceable against Duckworth it should also be enforceable against the Trustee. The Court noted there was no question the bank officer who prepared the documents made a mistake in preparing the Security Agreement, and even opined that it was confident the Bank would have been able to obtain reformation against Duckworth, if Duckworth had tried to avoid the Security Agreement based on the mistaken date. However, the position of the borrower was critically different than that of a bankruptcy trustee, who is tasked with maximizing the recovery for unsecured creditors. While a bankruptcy trustee typically stands in the shoes of the debtor, here the Trustee, in utilizing the "strong-arm" provisions of the bankruptcy code, could act as a hypothetical judicial lien creditor and void the defective security interest, even if the defect was not intended to mislead anyone. Accordingly, Lender's asserted security interest was not valid against a later creditor because that later creditor would be entitled to rely solely on the plain text of the Security Agreement.

In finding that the Security Agreement was to be enforced as written, the Court relied on prior decisions that stressed the importance of a third party's right to rely on unambiguous documents to determine the validity and priority of security interests. The Court recognized that such policy may produce harsh results, but reasoned that the interest in allowing parties to rely upon documents to mean what they say overcame all such concerns. The Court ultimately found that parol evidence cannot "be used to undermine the ability of later lenders (or bankruptcy trustees) to rely on unambiguous security agreements." Accordingly, the Court held that the mistaken identification of the debt to be secured cannot be corrected against a bankruptcy trustee by using parol evidence to show the

intent of the parties to the original loan, and reversed and remanded the matter for further proceedings.

As the title suggests, and *Duckworth* holds, when a loan document “walks like a duck and talks like a duck,” it is to be construed by the court “as a duck.” The lesson gleaned from *Duckworth* is to ensure the accuracy of your loan documents.

For More Information

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